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978-1-107-10093-0 - Reconceptualising Global Finance and its Regulation
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Introduction and Context

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Introduction

Douglas W. Arner, Ross P. Buckley and Emilios Avgouleas

The Global Financial Crisis (GFC) of 2008 should have caused a deep and profound rethinking of how financial markets work and are regulated, and of financial law more generally. The great depression of the early 1930s certainly did so, and resulted in a complete rethinking of banking and financial law in the United States with the enactment of the Securities Act of 1933[1] and the Securities Exchange Act of 1934[2] and the separation of commercial and investment banking by the Glass-Steagall Act of 1933,[3] as well as the establishment of the Bretton Woods system in the wake of World War II.[4]

The United Kingdom has had the Vickers Report[5] and the Kay Report.[6] The United States has had Dodd-Frank.[7] The European Union has had a plethora of directives and regulations.[8] But none of these reviews, reforms, or legislative

[1] Pub L No 73–22, 48 Stat 74 (1933), codified at 15 USC § 77a.

[2] Pub L No 73–291, 48 Stat 881 (1934), codified at 15 USC § 78a.

[3] The Glass–Steagall Act comprises ss 16, 20, 21, and 32 of the Banking Act Pub L No 73–66, 48 Stat 162 (1933).

[4] See Douglas Arner and Ross Buckley, 'Redesigning the Architecture of the Global Financial System' (2010) 11:2 *Melbourne Journal of International Law* 185.

[5] Independent Commission on Banking (ICB), *Final Report Recommendations* (12 September 2011) <http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf>. This report is often referred to as the 'Vickers Report' after Sir John Vickers, chair of the ICB.

[6] John Kay, *The Kay Review of UK equity markets and long-term decision making* (July 2012) <www.bis.gov.uk/assets/biscore/business-law/docs/k/12–917-kay-review-of-equity-markets-final-report.pdf>.

[7] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 111–203, § 2, 124 Stat 1376 (2010); G North and RP Buckley, 'The Dodd-Frank Wall Street Reform and Consumer Protection Act: Unresolved Issues of Regulatory Culture and Mindset' (2012) 35(2) *Melbourne University Law Review* 479.

[8] In the past 4 years, almost thirty legislative files relating to financial services have been passed by the European Parliament: Alex Barker and Martin Arnold, 'Super Tuesday for EU Bank Regulation', *Financial Times* (online) (15 April 2014) <www.ft.com/intl/cms/s/0/93dc374e-c4ba-11e3–9aeb-00144feabdc0.html#axzz2zrkNK9fV>. Examples include: Regulation (EC)

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measures has implemented changes that are truly fundamental, as was done in the 1930s, with the possible exception of the creation of the European Banking Union and the Single Supervisory Mechanism (SSM) in the EU. Australia had a substantial review of its financial sector underway in 2014 but the Financial Systems Inquiry[9] in no sense sought to reconceptualise Australia's regulatory regime. Likewise, the crisis has resulted in a series of pronouncements and regulatory reforms from the Group of 20 (G20) and the Financial Stability Board (FSB), both of which have been strengthened in the wake of the crisis.[10]

Yet, in our view, no jurisdiction has undertaken the sort of fundamental rethinking that the largest crisis since 1929 should have provoked, and that the crisis of 1929 did provoke. The reasons for this are many, but owe much to the political power of the financial sector generally, for the sector's extraordinary profitability of the past 20 years has brought with it extraordinary influence and power.[11] Likewise, compared to the establishment of the Bretton Woods system, the post-crisis international developments (namely strengthening of the G20 and FSB) have been very modest to say the least, once again with the possible exception of the SSM in the EU.

No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies [2009] OJ L 302/1 ('EU CRA Regulation'); Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board (the 'ESRB Regulation'); Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms ('EU Capital Requirements Regulation'); Committee of European Banking Supervisors, Guidelines on Remuneration Policies and Practices (10 December 2010) 60, 65 <www.eba.europa.eu/documents/10180/106961/Guidelines.pdf>.

[9] The Commonwealth government released the terms of reference of the Financial Systems Inquiry in December 2013 and initial submissions on the issues within these terms of reference closed on 31 March 2014: Australian Prime Minister and Treasurer, *Financial System Inquiry* (20 November 2013) <www.pm.gov.au/media/2013–11–20/financial-system-inquiry> and *Financial System Inquiry* (2014) <http://fsi.gov.au>.

[10] See Douglas Arner and Michael Taylor, 'The Global Credit Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?' (2009) 32 *University of New South Wales Law Journal* 488; Emilios Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (Cambridge University Press, 2012), chapters 6 and 7.

[11] In the fourth quarter of 1990 the profits of the US bank industry were $1.39 billion, in the second quarter of 2013 they were $42.2 billion, even allowing for the time value of money that remains a dramatic increase: Emily Stephenson, 'U.S. Bank Industry Profits Hit Record $42.2 Billion In Second Quarter', *Reuters* (online), 29 August 2013 <www.reuters.com/article/2013/08/29/us-financial-regulation-earnings-idUSBRE97S0O520130829>; and 'Bank Profits Fell 31% During Last Quarter of 1990', *The New York Times* (online), 14 March 1991 <www.nytimes.com/1991/03/14/business/bank-profits-fell-31-during-last-quarter-of-1990.html>. See also Luigi Zingales, 'How Political Clout Made Banks Too Big to Fail', *Bloomberg* (online), 30 May 2012 <www.bloomberg.com/news/2012–05–29/how-political-clout-made-banks-too-big-to-fail.html> and Simon Johnson and James Kwak, *13 Bankers* (Vintage, 2011), excerpt available at <http://13bankers.com/excerpt/>.

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The world of finance has changed profoundly in the past 40 years, but because the changes have been incremental, few people appreciate their scope and scale. We have selected 40 years as the time frame. In 1971 the United States went off the gold standard, the system put in place at Bretton Woods to keep finance national began to unravel, international financial markets began to globalise, and the initial moves to establish a single financial market and single currency in Europe began..

The massive changes in the past 40 years in what banks do, and who works within them, are two factors that lie at the heart of the GFC. Banking is a different industry than it was.[12] We need to assess how the international financial system has changed fundamentally in the past 40 years, and respond to these changes. So let us start with an overview of recent internationally mandated reforms. These comprise principally:

(i) Revising capital adequacy rules, with the introduction of Basel III
(ii) Seeking to end 'too-big-to-fail'
(iii) Monitoring and regulating the shadow banking system
(iv) Regulation of over-the-counter (OTC) derivatives
(v) Strengthening and converging accounting standards
(vi) Building a common Legal Entity Identifier system
(vii) Reducing reliance on credit ratings and improving oversight of credit rating agencies
(viii) Reforming compensation practices

These are eight significant initiatives, with which we largely agree.[13] Our issue with the response to the GFC has not been that it is wrong-headed, but simply that it has not gone far enough to respond to the profound changes in banking and capital markets of the past 40 years.

The reforms listed earlier, in the main, respond directly to the causes of the GFC and it is entirely understandable that a political process responds in this way to a crisis, that is, try to identify what caused the last crisis and work to preventing it from re-occurring. However, this is precisely what defence planners are derided for: preparing to fight the last war.

There will be another major financial crisis in the next decade or two; the history of the last 40 years (let alone of the last 400 years) assures us of this, and it almost certainly will not be like the GFC. We can be certain another major crisis is coming as we now have a globalised international financial system without a global financial regulator, a global lender of last resort or a global sovereign bankruptcy regime, and to be stable all national systems require a financial regulator, lender of

[12] See Chapter 2, Buckley, 'The Changing Nature of Banking and Why It Matters'.
[13] See, Ross P Buckley, 'The G20's Performance in Global Financial Regulation', (2014) 37 (1) *University of New South Wales Law Journal* 63–93; Douglas Arner, 'Adaptation and Resilience in Global Financial Regulation' (2011) 89 (5) *North Carolina Law Review* 1579.

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last resort, and bankruptcy regime.[14] These regulatory lacuna are unsurprising as Keynes and White in 1943 designed the postwar financial architecture to promote international trade but keep finance essentially national. In fact, as the financial market turmoil of mid-2015 indicates, we in fact may be quite close to the onset of the next crisis. So once we moved to a truly international financial system we needed new regulatory institutions which were missing, and while we have sought to provide such a regulatory superstructure through the Bank for International Settlements (BIS), FSB and other such bodies. But these are in no way an adequate replacement for the very great powers, formal and informal, of the financial regulator that all national financial systems need to be stable.

So if we are not to fall into the trap of engineering the global financial system to prevent the latest crisis, we must reconceptualise the system's regulation so that its regulation is truly responsive to the system as it is today. This is a much more difficult task than merely attempting to respond to the latest crisis, but given the latest crisis will not be the last, it is also absolutely necessary. It is the task we, and the other contributors, have set ourselves in this volume.

Funded by the Hong Kong Research Grants Council Theme-based Research Scheme project 'Enhancing Hong Kong's Future as a Leading International Financial Centre', the Centre for International Finance and Regulation, Sydney, as well as the University of Edinburgh, the University of Hong Kong, and UNSW Australia, this volume seeks to turn from analysis of the last crisis and the response thereto toward thinking forward to the needs of the international financial system and building legal and regulatory systems that will seek to reduce the likelihood and severity of future crises. It brings together the lion's share of the world's leading academics working in the area of financial law and regulation and seeks to identify issues and approaches for further attention going forward.

Reflecting this background and objective, the volume is divided into six sections. This first section seeks to provide analysis and context based on the ideas presented briefly in this introduction, namely considering the reality of today's

[14] RP Buckley, 'How the International Financial System, to Its Detriment, Differs from National Systems, and What We Can We Do About It', (2004) 34 *University of Hong Kong Law Journal* 321–338. Many commentators assume the IMF is the international lender of last resort, but the four elements of Walter Bagehot's classic prescription for a lender of last resort are that it is able to make available large amounts of capital, quickly, at high interest rates and on good security: Walter Bagehot, *Lombard Street: A Description of the Money Market* (Scribner, Armstrong & Co., 1873). However, the IMF lacks the resources to make available sufficiently large volumes of capital to quell market fears, often struggles to act quickly, does not for political reasons charge interest rates high enough to limit moral hazard, and sovereign borrowers typically lack the capacity to give good security over sufficient assets beyond their borders. So while much has changed since Bagehot wrote 'Lombard Street', if the IMF is truly to serve as a lender of last resort, we probably need to put in place some very extensive swap lines between national central banks that can be triggered quickly purely by the IMF, and even then, we are left with some very difficult to solve moral hazard problems with the IMF as initiator of those credit lines.

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global financial system and its regulatory context. Following this introduction, in Chapter 2, Ross Buckley of UNSW Australia considers first the evolution of banking and the implications of its new nature for regulatory design. In the third chapter, Lawrence Baxter of Duke University analyzes the real challenges of seeking to regulate globally active financial markets and institutions in a fragmented world of domestic legal systems.

The second section of the volume addresses the global financial architecture: the systems put in place at an international level to deal with the problems inherent in global finance. In the first chapter of this section (Chapter 4), Douglas Arner of the University of Hong Kong and Michael Taylor of Moody's discuss the evolution of the FSB and its role in the post-GFC regulatory environment. In Chapter 5, David Zaring of the University of Pennsylvania analyzes the development of the various financial networks that underlie the soft law approach to global finance embodied in the FSB. In Chapter 6, Chao Xi of the Chinese University of Hong Kong considers the specific context of China and the role of domestic influences in driving China's implementation of international standards in the context of Basel III.

The third section of the volume considers the changing role of central banks and the new challenges they are facing. In the first chapter of this section (Chapter 7), Donato Masciandaro of Bocconi University seeks to reconceptualise central banking in the wake of the GFC. Following this, Kern Alexander of the University of Zurich and Steven Schwarcz of Duke University discuss the new international focus on macroprudential supervision and its difficulties. In Chapter 9, Anna Gelpern of Georgetown University and Erik Gerding of the University of Colorado consider the problem of safe assets underlying many aspects of finance and regulation and find the current framework wanting in light of real-world issues.

The volume's fourth section turns to aspects of global finance requiring reconceptualisation. In Chapter 10, Wei Shen of Shanghai Jiao Tong University discusses the new environment of the internationalisation of China's currency, the RMB, and the challenges this poses to international financial centres. In Chapter 11, David Donald of the Chinese University of Hong Kong evaluates the central issues of market quality and moral hazard in financial market design. In Chapter 12, Ruth Plato-Shinar of Netanya Academic College analyzes the changing nature of bank secrecy and its role in post-GFC global finance. In Chapter 13, Amir Licht of the Interdisciplinary Centre Herzliya focuses on the challenges of quantitative analysis in global regulatory evaluation in considering the specific case of transnational securities fraud.

In the fifth section, the authors consider the specific challenges of too-big-to-fail / too-big-to-save financial institutions and shadow banking. Setting the stage, in Chapter 14, Emilios Avgouleas of the University Edinburgh discusses the inherent problems in large banks and their regulation. In Chapter 15, Dalvinder Singh and James Hodges of Warwick University consider the attempts to deal with regulatory

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enforcement in the regional context of the EU. In Chapter 16, Yingmao Tang of Peking University considers the emergence of shadow banking and the particular challenges in addressing it in a developing economy such as that of China. In Chapter 17, Robin Hui of the Chinese University of Hong Kong follows on from this with an in-depth analysis of the specific issues in China.

The final section of the volume seeks to consider the role of culture and ethics, perhaps in addition to regulation, soft or hard. In Chapter 18, Brian Tang of the Asian Capital Market Institute discusses the challenges and mechanisms mooted in the context of building professionalism in financial markets, including arguing for major efforts in this respect in Asia. In Chapter 19, Dirk Zetzsche of the University of Liechtenstein writes of the role of ethics in financial center competition in an environment of increasing regulatory harmonisation. In Chapter 20, Rolf Weber of the University of Zurich considers the specific challenges of addressing human rights in financial institutions policies and procedures. Finally, in Chapter 21, Sir William Blair of the High Court of England and Wales argues for reconceptualising the roles of professional standards in supporting regulation.

Looking forward, there remain significant opportunities to properly reconceptualise global finance and its regulation. Unfortunately, it may well require another crisis to truly do this.

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The Changing Nature of Banking and Why It Matters

Ross P. Buckley

INTRODUCTION

Banks have been a ubiquitous feature of almost all successful civilisations. Organisations discharging early banking functions operated in ancient Babylon,[1] and gained much greater sophistication in ancient Greece and Rome.[2]

When asked what they understand a bank to be, most people describe an institution that accepts deposits and makes loans – what we generally understand as a 'retail' bank.

However, the banks at the centre of our global financial system are utterly different. Entities such as JP Morgan Chase, UBS or Deutsche Bank do a great deal more than take deposits and grant loans.

Prior to the 1970s bankers were prudent, deeply cautious people who gave advice predicated on a good knowledge of the needs and interests of the customer.[3] Bank managers tended to have real authority as banks were quite decentralised

Sincere thanks to the Centre for International Finance and Regulation in Sydney, whose funding (project no. E135) supported the workshop in Hong Kong at which this was first presented, the research that underpins it, and the editing of this volume. CIFR is a Centre of Excellence for research and education in the financial sector funded by the Commonwealth and NSW Governments and supported by other consortium members (see www.cifr.edu.au). Thanks also for the enlightening feedback from participants at the Hong Kong workshop and to Rebecca Stanley and Ross Willing for their very helpful research assistance. All responsibility is mine.

[1] Richard Grossman, *Unsettled Account: The Evolution of Banking in the Industrialized World since 1800* (Princeton University Press, 2010), 30.

[2] See generally: W. V. Harris, *The Monetary Systems of the Greeks and Romans* (Oxford University Press, 2008); Paul Millet, *Lending and Borrowing in Ancient Athens* (Cambridge University Press, 2002); and Glyn Davies, *A History of Money: From Ancient Times to the Present Day* (University of Wales Press, 2002), chapter 3.

[3] Ismael Erturk and Stefano Solari, 'Banks as Continuous Reinvention' (2007) 12(3) *New Political Economy* 369.

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organisations, and thus bank managers tended to be highly respected members of their local communities.

These days are long gone. Most branches in my country, Australia, no longer have a full-time manager. Most Australians, at least the more sophisticated ones, understand that when a bank employee recommends a certain investment, they are typically incentivised by a commission to do so. Banks have changed from a relatively local institution working in the client's interests, to a far more complex organisation that is intent on maximising profits and the number of products it can sell to customers.

This change has been so dramatic that many of the world's largest and best-known banks are barely recognisable from the organisations they were in the 1970s, let alone their ancient forebears. The implications of those changes are profound, especially if we think of the economic consequences of the allocation of much of our most talented human capital away from high value-added roles in the real economy to the banking sector.

This chapter will seek to explore the full dimensions of this transformation and analyse why it matters for how we think about banks today, and the regulations we pass to govern them.

The chapter is in four further parts. First, it identifies the major changes that have occurred in banking over the past 40 years. Second, it analyses why banks exist – their core purposes. Third, it explores the implications of these major changes, in particular, as to how we should think about banks. And, finally, it concludes by suggesting that drawing a sharper distinction between a traditional bank and the new type of super-bank may be really useful for policy and public discussion.

CHANGES IN BANKING

Much of what occurs at international financial institutions would not be recognised as banking by the modern layperson. Indeed, even a banker from 40 years ago would hardly recognise what they would see today. If a lawyer from 1970 was brought forward in time and put in a modern day courtroom, most things would be familiar: the solemnity, the architecture of the court room, the mode of dress, the procedure, the objections being made by counsel. Since 1970 the manner of lawyers, the way they carry themselves, the way they are trained, the way they think and look backwards to find authority for what they propose doing, has all changed very little. Indeed, a lawyer transported forward in time from 17th century England would likewise see much in a contemporary courtroom they would recognise. Yet if a banker from as recently as 1970 was brought forward in time to 2015 and placed in a modern investment bank, or in the investment banking arm of a commercial bank, much would seem profoundly different.

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